to substitute simpler notice and comment procedures for existing paper hearing procedures in future represcription proceedings on our experiences in the 1990 represcription proceeding. At that time, we found that the Part 65 procedures go far beyond what is necessary to achieve the goals of our represcription proceedings.[145] We recognized that the discovery rules, which require a Bureau ruling prior to any involuntary discovery, were a cause of significant delay.[146] We are convinced that we should simplify our represcription procedures in order to eliminate unnecessary pleadings and delays and the attendant costs they impose on parties to represcription proceedings. Although almost all parties to this proceeding support some form of simplification, they emphasize that represcription proceedings are adversarial in nature and depend upon a thorough fact-based inquiry that develops a great amount of probative evidence. In recognition of this, even the parties who support simpler notice and comment procedures urge us to continue to promulgate rules that allow for, among other procedures, rebuttal pleadings and significant discovery, including interrogatories.[147] Such additions would, however, unduly complicate a notice and comment system, whose virtue is its simplicity in comparison to a paper hearing.

52. As a result, it is not clear what we would gain by abandoning paper hearing procedures, especially if one predictable result would be the filing of a large number of petitions requesting leave to file extraordinary pleadings and to engage in discovery. We find that the better approach is to revise our paper hearing procedures to provide for sufficient pleading opportunities to develop a full record and enough automatic disclosure of factual information to minimize procedural delay. Accordingly, we will retain current rule provisions that allow for the filing of direct, responsive, and rebuttal cases, and we will retain the time frames currently in place to govern the timing of the responses and rebuttals.[148] Thus, initial submissions (direct cases) will be limited to 70 pages and due sixty days following the release of the notice initiating a represcription proceeding. Responses will be limited to 70 pages and due 35 calendar days following the deadline for filing initial submissions. We agree with MCI that all parties should have rebuttal opportunity. Rebuttals will be limited to 50 pages and due 21 days after the deadline for filing responses. These procedures, in combination with the provisions we make for automatic disclosure and discovery,[149] should provide parties to future represcription proceedings with ample opportunities to examine and contest the submissions of other parties. We find that the revised procedures will further our goal of simplifying those proceedings while ensuring the

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[145] Notice, 7 FCC Rcd at 4692, para. 27.

[146] Id. at para. 33.

[147] See, e.g., MCI Comments at 9-10, 20-21.

[148] Because we replace the biennial represcription cycle with a semi-automatic trigger, see Section IV.A, infra, we eliminate Section 65.102(c)(1) of our rules, 47 C.F.R. §65.102(c)(1), which requires that initial submissions be filed on January 3 of each even numbered year.

[149] See infra Section IV.B.3.

development of a full and complete record during their course.

53. In view of the above, we eliminate Sections 65.104 ("Oral cross-examination of witnesses"), 65.105 ("Proposed findings of fact and conclusions"), and 65.106 ("Oral Argument") of our rules. As many commenters assert, these rules are not necessary to ensure the proper development of record evidence. In particular, proposed findings and conclusions and reply findings and conclusions burden parties without improving the decisional process. On the other hand, some commenters request that we affirm that we will entertain petitions for oral cross-examination and oral argument.[150] We do so declare, but caution that such petitions will need to show extraordinary circumstances and ordinarily will not be granted.

54. We also revise Section 65.100 ("Participation and notice of appearance") to eliminate required notices of appearance. Henceforth, interested persons may become parties to a represcription proceedings by filing pleadings in them. This procedure is similar to our procedure for other rulemaking proceedings.

55. We find that these streamlined paper hearing procedures satisfy statutory and constitutional due process requirements. We note that our decision not to adopt the notice and comment procedures we proposed does not result from a conclusion that we may not lawfully use simple notice and comment procedures to represcribe the rate of return authorized for LEC interstate access services. Both USTA and Rochester concede that Section 553 of the APA,[151] the statute that generally defines what administrative procedures are required of federal agencies, does not require trial-type hearings in ratemakings.[152] Only if an agency's enabling statute requires that rules "be made on the record after opportunity for an agency hearing" does Section 553 mandate trial-type procedures in addition to, or instead of, notice and comment procedures.[153]

56. We prescribe interstate rates of return for telephone companies pursuant to Section 205(a) of the Communications Act. The relevant inquiry, therefore, settles on whether that section, which allows the Commission to prescribe rates after "full opportunity for hearing," mandates that represcription proceedings include procedures in addition to those we adopt in this Order. Considering a similar statute, the Supreme Court held that the Interstate Commerce Commission ("ICC") did not have to employ trial-type procedures to develop rules addressing a nationwide shortage of railroad cars because the relevant statutory language (i.e., ratemaking "after hearing") did not require that rules be made "on the

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[150] See, e.g., Centel Comments at 7-8.

[151] 5 U.S.C. §553.

[152] See, e.g., USTA Comments at 13.

[153] See 5 U.S.C. §553(c) (trial-type procedures in 5 U.S.C. §§556 & 557 apply where enabling statute requires that rules be made "on the record after opportunity for an agency hearing").

record."[154] Thereafter, in Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council,[155] the Court determined that notice and comment procedures are legally sufficient in rulemaking proceedings unless the agency's enabling statute requires that the rulemaking be conducted "on the record."[156] Finally, in AT&T v. FCC,[157] the United States Court of Appeals for the Second Circuit found that, because Section 205(a) does not include the words "on the record," it could not be construed to require trial-type procedures.[158]

57. These cases make clear that simple notice and comment procedures are sufficient for represcribing the rate of return authorized for LEC interstate access services. Because the streamlined paper hearing system we adopt in this Order includes procedures in addition to simple notice and comment, we conclude that this system is also sufficient to represcribe that rate of return. We will revisit our decision not to adopt simpler notice and comment procedures if our experience with our revised paper hearing procedures proves unsatisfactory.

### 2. Participation

#### a. Overview

58. Part 65 requires certain LEC holding companies, namely the RHC offspring of the former Bell System, to participate in represcription proceedings because at the time we adopted Part 65 we applied rate of return regulation to the RHCs' operating companies.[159] Because the BOCs are now regulated under price caps, the Notice questioned whether we should continue to rely on the RHCs as primary information sources in represcription proceedings.[160] We specifically asked whether we should continue to obtain needed data from the RHCs if these companies, now regulated under our price cap rules, face risks different from those rate of return-regulated LECs face in the provision of interstate access

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[154] Id. See also United States v. Florida East Coast Railway Co., 410 U.S. 224 (1973) (statute's "after hearing" requirement was not equivalent to language that would require trial-type procedures).

[155] 435 U.S. 519 (1978).

[156] Id.

[157] 572 F.2d 17 (2d Cir. 1978).

[158] Id.

[159] See 47 C.F.R. §§65.1(a), 65.200. We originally limited required participants to these large companies because our comparable firms analysis was based on those firms listed on the New York Stock Exchange. We did not include other stock exchanges in the comparable firms analysis because we concluded that this would needlessly add to the costs of analysis in represcription proceedings. See Phase II Order, supra, at para. 47.

[160] Notice, 7 FCC Rcd at 4694, para.41.

service.[161] We asked commenters to suggest alternative information sources, and suggested that, even if we continue to rely on RHC data, such data might be collected and submitted by a LEC organization such as the National Exchange Carrier Association, Inc. ("NECA"), rather than by the RHCs.[162] Accordingly, we proposed to make NECA the only mandatory participant in future represcription proceedings and to require it to collect and process any information needed to support our triggering and cost of capital methodologies.[163] We invited comment on what this might cost NECA and on whether we should require NECA to classify its participation costs as Category I expenses.[164]

### b. Comments

59. A few commenters would have us continue to rely on RHC data, contending that circumstances have not changed significantly since the 1990 represcription proceeding in which we relied on such data,[165] or that RHC returns on assets and shareholder equity, and debt-to-equity ratios compare closely to historical composite data of USTA members.[166] Even some of these commenters state that RHC data will need to be adjusted to take into account the different risk characteristics faced by the smaller LECs.[167] Most commenters, however, urge us to cease relying on RHC data, arguing that the risk characteristics of the RHCs in providing interstate access service no longer track those of the smaller LECs, and, accordingly, that it would be better to obtain data from sources that reflect similar risk characteristics. [168]

60. Most of these commenters urge us to use BOC data as a new surrogate data source.[169] There is little support even among these commenters, however, for requiring BOC participation in represcription proceedings. Instead, these commenters state that we can

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[161] Id.

[162] Id.

[163] Id.

[164] Id. at para. 42. Section 69.603(h) of our rules, 47 C.F.R. §69.603(h), requires NECA to classify its costs as either Category I, which are included in interstate revenue requirement and revenue distribution computations, or Category II, which are excluded from those computations.

[165] NTCA Comments at 4.

[166] Frederick and Warriner Comments at 3.

[167] See Centel Comments at 8-9. See also FWA Comments at 6.

[168] See, e.g., FWA Comments at 6; Rochester Comments at 24-27.

[169] See, e.g., Delhi Comments at 1-2; Kaleva Comments at 1-2; Nebraska Central Comments at 1-3; OPASTCO Comments at 3.

easily obtain any necessary data from materials on public file with the Commission, including Automated Reporting Management Information System ("ARMIS") reports.[170] SBA asserts that BOC participation is unnecessary given that these carriers are now regulated under price caps.[171] The BOCs agree, and point out that the Notice specifically stated that its proposals would apply only to those LECs not subject to price cap regulation.[172] US West, for example, claims that we should reaffirm that those proposals do not apply to price cap LECs.[173] US West contends that otherwise our actions in this rulemaking will affect the parameters of the sharing obligations currently imposed on price cap LECS as well as our LEC price cap performance review.[174]

61. GSA, in contrast, would require the participation of the RHCs or BOCs because, in GSA's view, even carriers now subject to price cap regulation would be directly affected by a change in the authorized rate of return. This is so, according to GSA, because the price cap mechanism imposed on the LECs includes a sharing mechanism that is, in part, calibrated to the rate of return otherwise used to initialize price cap carrier rates. Thus, GSA argues that changes in the authorized rate of return should automatically affect the sharing requirements for price cap LECs.[175] Ameritech, in reply, says that parties like GSA misunderstand the nature of our LEC price cap system. According to Ameritech, that system does not contemplate sharing zone adjustments, such as would occur under GSA's interpretation, every time the Commission represcribes the rate of return.[176]

62. Several commenters support allowing NECA to collect needed information, and some oppose that approach. SBA argues that we should compel NECA to participate in represcription proceedings because NECA has the resources to gather and process the

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[170] See, e.g. Community Service Comments at 1-2. Since the Notice was released, we revised the Annual Report Form M ("Form M") and incorporated it into our ARMIS system. ARMIS is an automated system consisting of ten reports containing financial and statistical data the we use to administer our accounting, joint cost, jurisdictional separations, rate base, and access charge rules. LECs with annual revenues of $100 million or more must file ARMIS reports. ARMIS Report 43-02 contains LEC financial information, and ARMIS Report 43-08 contains LEC statistical information. See Revision of ARMIS USOA Report (FCC Report 43-02) for Tier 1 Telephone Companies and Annual Report Form M, Memorandum Opinion and Order, 8 FCC Rcd 2535 (1993). To avoid confusion, this Order refers to ARMIS rather than to the now obsolete, Form M.

[171] Id.

[172] See, e.g., US West Comments at 1-2.

[173] Id.

[174] Id.

[175] GSA Comments at 2-4. See also MCI Comments at 23.

[176] Ameritech Reply at 2-5. Accord BellSouth Reply at 4 (GSA analysis would "convert price cap regulation into a banded rate of return mechanism with a price cap overlay"); NYNEX Reply at 1-3; Pacific Reply at 2-4.

information necessary to develop a rate of return.[177] NECA itself agrees to serve as information gatherer and processor, but only if the Commission authorizes it to recover the associated costs in an appropriate manner.[178] NECA notes, however, that it does not ordinarily collect the information needed for a represcription proceeding from its members. Accordingly, NECA states that if it were given data gathering and processing responsibilities, it would need to rely on publicly available data or data from commercial sources.[179] FWA, however, opposes NECA's participation because, in its view, NECA's involvement as information gatherer is unnecessary.[180]

### c. Discussion

63. As discussed more fully in Section V, infra, we agree with those commenters who argue that, because the RHCs no longer face risks comparable to those faced by carriers subject to rate of return regulation, RHC data may no longer serve as the best data upon which to base a uniform rate of return prescription. Accordingly, it would be inappropriate to require the participation of the RHCs in future represcription proceedings absent other compelling factors. The only compelling factor raised in the comments is the impact of a rate of return represcription on price cap LECs. Under our present rules, that impact arises in only limited areas. These include possible changes in the amounts that price cap LECs receive from the Universal Service Fund or pay for long-term support of NECA's common line pool;[181] possible changes in price cap LECs' accounting for those affiliate transactions that our rules require LECs to record at costs;[182] and possible changes to the amounts those LECs pay the Telecommunications Relay Services Fund to give hearing-impaired users full access to the voice telecommunications network.[183]

64. The question of what, if any, additional impact future rate of return represcriptions will have on price cap LECs is not before us here. As we indicated in the

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[177] SBA Comments at 11 (NECA's participation should lower participation costs of small LECs).

[178] MCI Comments at 23; NECA Comments at 5-6 (costs would not be significant and should be recovered as Category I expenses).

[179] NECA Reply at 15.

[180] FWA Comments at 7 (Commission should gather necessary information directly from industry if necessary).

[181] Both of these programs distribute interstate revenue based on the prescribed interstate rate of return. See 47 C.F.R. §§ 36.601-36.631, 69.607-69.612.

[182] See Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates, Notice of Proposed Rulemaking, CC Docket No. 93-251, 8 FCC Rcd 8071, 8095-96, para. 66 (1993).

[183] See 47 C.F.R. § 64.604.

Notice, the scope of this proceeding is limited to those LECs who remain subject to rate of return regulation.[184] Moreover, we elect not to require NECA or any other interested person -- including the BOCs -- to participate in represcription proceedings at this time. We agree with those commenters who point out that much relevant data -- whether BOC specific, large carrier specific, or small carrier specific -- is generally available and publicly filed with this Commission. Any additional data needed during a represcription proceeding can be obtained though discovery or Bureau information requests.

### 3. Discovery

#### a. Overview

65. Section 65.103(a) of our rules currently permits written interrogatories and document requests directed to rate of return submissions and "upon any matter, not privileged, that will demonstrably lead to the production of material, relevant, decisionally significant evidence."[185] Discovery requests are due within fourteen days after the filing of the submission to which they relate; oppositions are due seven days thereafter.[186] In the Notice, we found, based on our experience in the 1990 represcription proceeding, that these discovery provisions had been a qualified success.[187] Although we concluded that discovery had contributed to a full and fair record in that proceeding, we also found that it entailed considerable effort on the part of the Commission. Most of this effort was required because the current rules provide little guidance on what is discoverable and because those rules require the Bureau to rule on discovery requests prior to any involuntary discovery.[188] We tentatively concluded that we could streamline discovery without jeopardizing the development of a full and fair record.[189]

66. We proposed a number of specific changes to our discovery rules. First, we proposed to require the automatic disclosure of much, if not all, of the information usually obtained through discovery. We proposed that parties should automatically file studies, financial analysts' reports, and other documents that parties' experts rely upon in preparing their presentations.[190] Second, we asked whether we should expand the role of Bureau

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[184] Notice, 7 FCC Rcd at 4688-89, paras. 1-9.

[185] 47 C.F.R. §65.103(a).

[186] Id.

[187] Notice, 7 FCC Rcd at 4692, para. 33.

[188] Id.

[189] Id. at para. 34.

[190] Id.

information requests.[191] The current rules authorize the Bureau to require represcription proceeding participants to submit data or studies that are "reasonably calculated to lead to the development of a full and fair record."[192] Third, we proposed to eliminate written interrogatories even if we retained other types of discovery.[193] We stated that represcription proceedings depend significantly on expert economic analysis, but that interrogatories often add little more to the record than multiple reiterations of the parties' positions.[194]

67. Finally, we asked parties to comment generally on how discovery should proceed if it were retained.[195] We stated that we saw no reason to change the current rule that involuntary discovery requires prior Bureau rulings so long as we further streamlined discovery itself, as proposed in the Notice.[196] If these proposals were adopted, we reasoned, there would be fewer discovery requests because most decisionally significant information would be automatically made available to all parties during the proceeding. We indicated that prior Bureau review of discovery requests, under these circumstances, might serve our goal of reducing the burdens of the represcription process.[197] If the current discovery rules were retained, however, we proposed to facilitate discovery by requiring parties to comply with discovery requests unless they first obtained protective orders.[198] We asked commenters to address this proposal and invited alternative proposals that might reduce discovery burdens.[199] We also asked commenters to address what schedule we should employ if we were to adopt a notice and comment procedure that allows for discovery.[200]

### b. Comments

68. Most commenters on discovery matters agree that our discovery procedures can be simplified, but all urge us to affirm that adequate discovery is essential to highly adversarial proceedings like rate of return represcription proceedings. Thus, Rochester and

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[191] Id. at para. 35.

[192] 47 C.F.R. §65.102(a).

[193] Notice, 7 FCC Rcd at 4693, para. 36.

[194] Id.

[195] Id. at para. 37.

[196] Id.

[197] Id.

[198] Id.

[199] Id.

[200] Id.

USTA would initially curtail discovery by substituting a certain amount of self-executing disclosure for the current system.[201] Rochester and USTA would have us require parties to produce workpapers and related background documents, upon request, for the Commission and other parties within ten days of the filing of related pleadings.[202] According to Rochester, this type of self-executing discovery should virtually eliminate the need for interrogatories, but the Commission should recognize that interrogatories can still be necessary or, at least, useful as a device to test factual presentations.[203] Rochester maintains that the Commission should allow fact-based interrogatories under specified circumstances and according to a schedule that we could include in the notice commencing the represcription proceeding.[204] Rochester and USTA argue that the Commission should not substitute Bureau data requests for discovery because such requests may not satisfy the needs of all parties.[205]

69. MCI argues that the Commission's rules should recognize that represcription proceedings are highly adversarial and include disputes over controversial issues like the cost of equity. MCI asserts that this means that pleadings in represcription proceedings resemble adjudicatory briefs, and the Commission's rules must afford participants ample opportunity to develop and argue the record.[206] Accordingly, MCI says that the Commission should require significant automatic disclosure[207] and encourage Bureau information requests.[208] MCI also

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[201] Rochester Comments at 19; USTA Comments at 26 (opportunity for additional discovery should be available in context of filing of direct and responsive cases).

[202] Rochester Comments at 19-20 (materials produced upon request of party within ten days of filing of direct case, responsive case or rebuttal case, as appropriate); USTA Comments at 28-29 (automatic service of materials on all parties would be wasteful; materials should be produced upon request of party within ten days of filing or upon request of the Commission at any time).

[203] Rochester Comments at 20.

[204] Id. See also USTA Comments at 30 (Part 65 rules need not specifically provide for interrogatories, but interrogatories should be available for good cause shown).

[205] Rochester Comments at 19 & 21; USTA Comments at 31. See also BellSouth Comments at 2.

[206] Id. at 10.

[207] Id. at 17-19 (automatic disclosure of all financial analysts' reports and other data upon which a party relies in its comments, reply comments, or rebuttals at the time such pleadings are filed; includes all raw data and statistical analyses in hard copy and machine-readable form; statistical analyses of data must be supported by sufficiently large data universe to allow critical evaluation of criteria used to support analyses).

[208] Id. at 20-21 (Bureau information requests as supplement to discovery by parties; information requests should be used to obtain unforeseen categories of data going beyond data automatically filed; Bureau should allow parties to request that it obtain particular data and information pursuant to bureau information requests).

contends that the Commission should permit discovery, including interrogatories.[209]

70. GSA also would require automatic discovery of certain information at the beginning of a represcription proceeding, including: (1) RHC DCF calculations using Institutional Brokers Estimate Service ("IBES") growth estimates; (2) S&P 400 DCF calculations by quartile; (3) Utility and Treasury bond yields; and (4) recent state commission rate of return findings.[210] Such automatic discovery should also include studies, financial analysts' eports and other documents relied upon by experts, according to GSA, since this would reduce overall discovery burdens.[211]

### c. Discussion

71. We agree with those commenters who argue we can largely eliminate the costs and delays attendant to represcription proceedings if we require that parties automatically file all studies, financial analysts' reports, and other documents relied upon to prepare their direct, reply and responsive cases. Accordingly, we will revise our rules to direct parties to file such information with the Commission at the time they file their direct, reply and responsive cases.[212] Generally, we expect that interested persons and parties will obtain copies of the filed pleadings and other information, including information available through automatic discovery, from the Commission's duplicating contractor. However, we will also order parties to serve copies on those parties who request direct service.[213] Because information technology and our ability to use it change constantly, we do not at this time specify the format (e.g., hard copy, machine readable) parties should employ to file pleadings and information with the Commission and with parties requesting direct service. Instead, we will address such matters in the notice initiating a represcription proceeding.

72. Given mandated, "automatic" discovery of the material described above, we largely retain our current rules governing written interrogatories and document requests. Although we believe that automatic disclosure will greatly reduce the need for these discovery methods, we are persuaded by the commenters that additional discovery methods including interrogatories, should be available to "capture" any material, relevant, and

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[209] Id. at 21-22 (unless opposed, discovery requests should be answered without Bureau order; answers or objections should be filed within 2 weeks after discovery requests are served; where Bureau grants contested discovery, opponent should file answer within 1 week of Bureau order; all discovery requests must be filed with Commission to ensure that record is complete, i.e., even after close of rebuttal filings; discovery responses should be made available to all parties to a represcription proceeding).

[210] Id. at 11-12 (enumerated information should be centrally filed).

[211] Id.

[212] See Appendix 4, 47 C.F.R. § 65.105(a).

[213] See Appendix 4, 47 C.F.R. §§ 65.100(b), 65.105(a).

decisionally significant evidence not otherwise submitted. Because such additional discovery will be extraordinary, we do not believe that the need for the Bureau to act on discovery requests will unduly slow the represcription process. We will, however, make clear that parties must honor unopposed additional discovery requests within 14 days.[214] We need not, at this time, decide whether parties should automatically file with the Commission all materials that are the subject of additional discovery requests and, thus, make the materials available to all parties in a represcription proceeding. Predictably, in some cases, this would necessitate taking steps to protect confidential information by such means as protective orders. We will address these issues as the need arises once a represcription proceeding is initiated. Finally, we will continue to allow for Bureau information requests.[215] Nevertheless, while we view such Bureau requests as a valuable tool in developing a full record for Commission decision making, we are not persuaded that they should substitute for discovery as was proposed in the Notice.

### 4. Requests for Individualized Rates of Return

73. In the Notice, we proposed to retain Sections 65.101 and 65.102(c)(2),[216] which provide a mechanism for LECs to seek individualized rates of return.[217] These rules allow a carrier to avoid the prescribed unitary rate of return by showing that, in its case, the prescribed cost of capital is "so low as to be confiscatory because it is outside the zone of reasonableness for the individual carrier's required rate of return for exchange services."[218] To make its case, the carrier must show exceptional facts and circumstances that are not transitory and that would justify individualized treatment for at least two years.[219] The rules contemplate that carriers ordinarily will file requests for individualized treatment at the time participants file responsive pleadings in rate of return represcription proceedings, although carriers may file petitions at any time.[220] If a carrier files a petition at a time other than the date for filing responsive pleadings, the rules require the petitioner to show "that the fluctuation in earnings requirements is not the result of short term fluctuations in the cost of capital or similar events."[221] In the Notice, we requested comment on how we might modify

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[214] See Appendix 4, 47 C.F.R. § 65.105(c).

[215] See Appendix 4, 47 C.F.R. § 65.103(a).

[216] 47 C.F.R. §§65.101, 65.102.

[217] Notice, 7 FCC Rcd at 4694, para. 43.

[218] 47 C.F.R. §65.101(a).

[219] Id. §101(b).

[220] See id. §§65.101(b), 65.102(c)(2).

[221] Id. §65.101(b).

these requirements to conform them to any new procedures adopted in this proceeding.[222]

74. All commenters who addressed the issue agree that we must make available to qualifying carriers procedures to enable them to obtain an individualized rate of return prescription upon a proper showing. These commenters agree, however, that we should grant individualized treatment only if a petitioning carrier shows unique and persisting circumstances.[223] Accordingly, we believe we should retain the requirements of Section 65.101 governing LECs who wish to obtain individualized rates of return. The current rule requires carriers seeking individualized rates of return to justify a prescription for a two-year period. Although this latter proviso was intended to accommodate the biennial represcription cycle that this Order abandons,[224] we are convinced that individualized prescriptions must be limited to require regular demonstrations that cost of capital variances sufficient to warrant the individual prescription continue.

75. In addition, in a subsequent portion of this Order, we eliminate the current requirement for carriers in group represcription proceedings to file comparable firms analyses.[225] Consistent with that action, we also eliminate the requirement for such analyses from the individualized rate of return rule. With this exception, we retain all current elements of the showing required by LECs to justify an individualized rate of return.

## V. Cost of Capital Methodologies

### A. Overview

76. The LECs' cost of capital is the rate of return they must earn to attract investment funds. By judicial standards, each LEC must receive the opportunity to earn a rate of return "commensurate with returns on investments in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, as to maintain its credit and to attract capital."[226] On the other hand, the countervailing interests of the ratepayers require that "the return should not be higher than

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[222] Notice, 7 FCC Rcd at 4694, para. 44.

[223] FWA Comments at 7 (carriers should be allowed to show that exceptional facts and circumstances that will persist for at least two to three years justify an individualized rate of return); Frederick and Warinner Comments at 2 (carriers must show exceptional facts and circumstances to obtain individual prescription); USTA Comments at 24-25 (current rules governing exceptional treatment can be eliminated, but Commission must make some provision for carriers to obtain individual treatment).

[224] See infra Section IV.A.

[225] Compare infra Section V.C.3 with 47 C.F.R. §65.101(a).

[226] FPC v. Hope Natural Gas, 320 U.S. at 603.

necessary for this purpose..., because otherwise ratepayers would pay excessive prices that regulation is intended to prevent."[227] In represcription proceedings, we use estimates of the cost of capital for LEC interstate access services to determine a zone of reasonableness that is narrower than the zone defined by these standards,[228] and we use this narrower zone to prescribe a unitary, overall rate of return for rate of return LECs.[229] The LECs' actual, future rates of return may differ from the prescribed rate.

77. Part 65 of our rules sets forth three basic approaches for estimating the cost of capital for LEC interstate access services. The first approach uses the rates of return authorized for the BOCs' intrastate operations in each state where a BOC is the principal exchange carrier.[230] The second uses a composite of the RHCs' weighted average costs of capital.[231] The third uses a composite of the weighted average costs of capital of firms deemed comparable to providers of interstate access services. The rules specify various screens for selecting comparable firms.[232]

78. Part 65 requires the RHCs to file the state rate of return and RHC cost of capital information at the start of each represcription proceeding.[233] The rules set forth complicated methodologies for computing the RHCs' and the comparable firms' costs of capital. These methodologies require the computation of a weighted average cost of capital for each RHC and comparable firm based on its outstanding long-term debt, equity, and, where applicable, preferred stock, and the proportion of each in its capital structure.[234] The rules contemplate that, in represcription proceedings, we will utilize our best judgement in determining the weight, if any, to be accorded to the estimates these basic approaches produce. Parties to represcription proceedings may urge, and the Commission may adopt, cost of capital methodologies other than those specified in the rules.[235]

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[227] United States v. FCC, 707 F.2d 610, 612 (D.C. Cir. 1983).

[228] 1990 Represcription Order, 5 FCC Rcd at 7540, n.314.

[229] This rate of return is used to determine each rate of return LEC's revenue requirements, in accordance with the formula set forth in para. 7 of this Order.

[230] 47 C.F.R. §65.201(a).

[231] Id. §§65.201(b), 65.300-65.304.

[232] Id. §65.400.

[233] Id. §65.201.

[234] Id. §§65.300-65.304.

[235] See 84-800 Phase II Order, 51 Fed. Reg. at 1800.

## B. Proposed Changes

79. In the Notice, we stated that we would continue to use a weighted average cost of capital calculation to estimate the cost of capital for LEC interstate access service.[236] We proposed, however, to reduce the burden of future represcription proceedings by using simplified methodologies to determine the components of the weighted average cost of capital calculation. We, therefore, invited comment on alternative, streamlined methodologies for determining the cost of equity, the cost of debt, the cost of preferred stock, and the proportion of each in the capital structure.[237]

80. We also invited comment on the role that methodologies specified in the rules should play in future represcription proceedings. For the cost of equity component, we proposed to retain our policy of determining the weight to be accorded any methodology at the point we represcribe the authorized interstate rate of return. For the non-equity components, we proposed to make methodologies specified in the rules either presumptive or conclusive in future represcription proceedings. We explained that a presumptive methodology would be used in future represcription proceedings, unless the record were to show that it would produce unreasonable results.[238]

## C. Cost of Equity

### 1. Overview

81. The cost of equity relates to the sale of common stock to finance LEC interstate access services. Part 65 prescribes a "historical" discounted cash flow (DCF) methodology to compute this cost. The rules calculate the cost equity as:

D/P + G, where:

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[236] This calculation can be expressed as:

$$C = [(D/(T)) \times i] + [(P/(T)) \times p] + [(E/(T)) \times e]$$

where C is the weighted cost of capital;
D is the book value of the debt;
P is the book value of the preferred stock;
E is the book value of the common stock;
T is equal to E + D + P;
i is the cost of debt;
p is the cost of preferred stock; and
e is the cost of equity.

[237] Notice, 7 FCC Rcd at 4694-700, paras. 45-87.

[238] Id. at 4694, para. 47.

D is the estimated annual dividend on a share of common stock,

P is the price of a share of common stock, and

G is the estimated long-term growth rate of dividends.[239]

Under this methodology, the cost of using common stock to finance operations can be equated with the sum of the expected dividend yield on common stock plus the expected growth rate of future dividends.

82. The rules require the RHCs to submit data reflecting two variations of the DCF methodology. Both variations use the average share price over a two-year period preceding a represcription filing for P, and the average dividend paid during that two-year period for D. The first, or G1, variation uses the growth in dividends that actually occurred during the same two-year period to determine the dividend growth factor. The second, or G2, method averages analysts' growth forecasts for the firms as reported by IBES[240] over that same period. The forecasts in each report are averaged, through use of the median, to derive a composite forecast.[241]

83. In the Notice, we proposed numerous changes in the way cost of equity is calculated. These proposals concerned "historical" DCF, "classical" DCF, stock prices, dividends, growth in dividends, quarterly compounding,[242] flotation costs,[243] and risk premium analyses.[244] We also described a variant of risk premium analysis called the capital asset pricing model ("CAPM"), which, in contrast to other risk premium methods, derives a risk premium for each company by using the variance of the company's stock price relative to the stock market as a whole.[245]

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[239] 47 C.F.R. §65.303. This methodology is "historical" because it relies on past growth. In contrast, classical DCF methodologies rely on forecasts of future growth.

[240] IBES is the Institutional Brokers Estimation Service. It presently publishes, on a monthly basis, institutional analysts' forecasts of the five-year rate of growth of earnings for listed stocks.

[241] 47 C.F.R. §§65.303-65.304.

[242] Quarterly compounding refers to an adjustment to the DCF formula to account for the payment of dividends on a quarterly, rather than annual, basis.

[243] Flotation costs refer to the temporary reduction in the market value of a stock caused by the issuance of additional shares of that stock.

[244] Notice, 7 FCC Rcd at 4695-98, paras. 54-75. Risk premium analyses estimate the cost of equity by adding a risk premium to the current yield on a relatively "risk-free" investment, such as long-term United States Treasury bonds.

[245] Id. at 4697, paras. 68-69.

### 2. Comments

84. The commenters generally oppose codifying a cost of equity methodology in the rules.[246] Small LECs believe a codified methodology would restrict the Commission's flexibility, complicate future represcription proceedings, and contradict the Commission's simplification objectives.[247] Others contend that the cost of equity is not directly observable.[248] They maintain that estimating the cost of equity continues to require judgment and sophisticated analysis.[249] Given the dynamic nature of the capital markets and the evolving nature of the study of finance, commenters state that it is difficult, if not impossible, to reach consensus on the proper methodology to determine a fair rate of return on equity that produces the most accurate results at a given time.[250] In addition, the commenters state that presumptive or conclusive methodologies would, in effect, preclude the use of other methodologies and prejudge the issues.[251]

85. Most commenters advocate a flexible approach where the Commission considers all cost of equity methods and relevant evidence instead of codifying or using one method.[252] USTA suggests that the Commission should permit the utilization of all cost of equity methods in use by the financial and academic communities at the time of a represcription. USTA states that having a range of estimates available would reduce the chance of error, provide a measure of confidence that the result will be reasonable, and be preferable to relying on only one or two prescribed methods.[253]

86. Some commenters, however, oppose particular methods. FWA is against CAPM, because most small LECs are not publicly traded.[254] Centel argues that risk premium analyses should not use ten-year Treasury bonds as the "risk-free" investment,

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[246] See, e.g., USTA Comments at 47; Bell Atlantic Comments at 3; MCI Comments at 24; SBA Comments at 12; SNET Comments at 6; SWBT Comments at 2; United Comments at 5.

[247] See, e.g., Blossom Comments at 1; Mid-Iowa Co-op Comments at 2; Rural Telephone Service Comments at 2; UTELCO Comments at 2-3.

[248] Bell Atlantic Comments at 3; USTA Comments at 3.

[249] Bell Atlantic Comments at 3.

[250] USTA Comments at 48; SNET Comments at 6; SWBT Comments at 2; Rochester Comments at 29-30.

[251] SWBT Comments at 2; Rochester Comments at 29-30; MCI Comments at 24.

[252] See, e.g., SWBT Comments at 2; United Comments at 5; USTA Comments at 40.

[253] USTA Comments at 48-49.

[254] FWA Comments at 10.

because the lives of these bonds are too short. According to Centel, the investment's duration should be more comparable to the infinite maturity of common stock; Centel recommends thirty-year Treasury bonds or Aa utility bond.[255] MCI suggests that the Commission should require LECs to submit, at the outset of a represcription proceeding, classic DCF data for each quartile of the S&P 400, without prespecifying any portion as a possible benchmark.[256] SBA is indifferent to whether the DCF and the risk premium methods are used, but believes these methods will be accurate if properly specified. SBA recommends, however, that in applying these methods, we use stock indices for companies that mirror the financial resources of small LECs, rather than relying on the S&P 400, the largest 100 utilities, or other groupings from the New York Stock Exchange ("NYSE").[257]

87. Few commenters address two issues the Notice raised regarding the application of the DCF formula: quarterly compounding of dividends and the inclusion of flotation costs in the cost of equity. Centel and USTA maintain that quarterly compounding is not difficult to apply with current spreadsheet software and that DCF computations should reflect the quarterly payment of dividends.[258] Rochester states that the Commission should not prejudge quarterly compounding or flotation costs by adopting rules or methodologies that effectively reject them.[259] USTA maintains that we should allow participants in represcription proceedings to seek an adjustment for flotation costs, despite the lack of any separately recorded, out-of-pocket costs for the issuance of equity shares.[260] FWA opposes an allowance for flotation costs because small LECs do not sell additional stock through offerings to the general public.[261] MCI opposes as unnecessary both quarterly compounding of dividends and an allowance for flotation costs.[262]

### 3. Discussion

88. Equity prices are established in highly volatile and uncertain capital markets. The theories and methodologies analysts use to forecast these prices represent a rapidly expanding field of study. Different forecasting methodologies compete with each other for eminence, only to be superseded by other methodologies as conditions change. In addition,

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[255] Centel Comments at 12.

[256] MCI Comments at 27.

[257] SBA Comments at 12-13.

[258] Centel Comments at 11; USTA Comments at 53-54.

[259] Rochester Comments at 31-32.

[260] USTA Comments at 54.

[261] FWA Comments at 9.

[262] MCI Comments at 26.

each methodology has a number of permutations. Besides the number of methodologies available, there is the problem that each methodology assumes certain conditions that may, or may not, persist over time.[263] In these circumstances, we should not restrict ourselves to one methodology, or even a series of methodologies, that would be applied mechanically. Instead, we conclude that we should adopt a more accommodating and flexible position. To the extent resources permit, the final cost of equity in a represcription proceeding should represent a judgment reached after considering a wide variety of data and methodologies.

89. The flaw in the current rules governing determination of cost of equity is that they ignore these basic principles. Although those rules do not require the Commission to apply any particular methodology in estimating the cost of equity, they require the RHCs to apply two "historical" versions of the DCF formula and to submit the resulting data for inclusion in the record in represcription proceedings.[264] In the two represcription proceedings conducted under the Part 65 rules, we gave very little or no weight to these data.[265] Those rules also specify criteria for determining when firms have risks characteristics comparable to those of interstate access services.[266] In the 1986 represcription proceeding, we found significant problems with these criteria and gave analyses relying on them little weight.[267] In Docket 87-463, we proposed to improve the criteria by incorporating a cluster analysis.[268] In the 1990 represcription proceeding, we considered several cluster analyses presented by the parties and found them to be entitled to no weight because the analyses had failed to identify firms for which risks were comparable to those of interstate access service.[269]

90. These experiences have made us acutely aware that any cost of equity methodology we codify may not withstand the test of time. In these circumstances, we agree with the majority of the commenters that our rules should specify no cost of equity

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[263] See, e.g., Howard E. Thompson, Regulatory Finance: Financial Foundations of Return Regulation 8 (1991); Roger A. Morin, Regulatory Finance: Utilities' Cost of Capital 17 (1994).

[264] 47 C.F.R. §65.303.

[265] 1990 Represcription Order, 5 FCC Rcd at 7512, para. 48 (no weight); 1986 Represcription Order at para. 36 (very little weight).

[266] 47 C.F.R. §65.400.

[267] 1986 Represcription Order at paras. 19-23.

[268] See 1987 Notice, 2 FCC Rcd at 6493-94, paras. 18-28. Cluster analysis uses criteria to separate companies listed on the NYSE into discrete groups and to evaluate the risk characteristics of interstate access service. The group whose risk characteristics appear closest to those of interstate access service are deemed comparable to the entities that provide that service. Id.

[269] 1990 Represcription Order, 5 FCC Rcd at 7526, paras. 161-66.

methodology on which data would have to be submitted at the start of represcription proceedings. Instead, we will leave open all issues involved in the forecasting of equity costs. These open issues include questions regarding the data that we should use in applying particular methodologies, flotation costs, periods of compounding, and similar issues. In addition to simplifying the rules, this action will avert a potential unnecessary burden on the parties to future represcription proceedings.

91. In taking this action, we emphasize that the rules we adopt in this Order permit the Bureau to require interested persons to submit any information it deems necessary to decide, once the triggering event occurs, whether to institute a represcription proceeding or to develop the record, once a represcription proceeding begins.[270] This procedure will minimize the possibility that parties to future represcription proceedings will have to file data that proves useless. It places on interested persons the responsibilities to respond in a timely manner to Bureau data requests and to submit any additional information they believe will help us accurately estimate the cost of equity for LEC interstate access services.

## D. Cost of Debt

### 1. Overview

92. The cost of debt relates to the sale of bonds and other fixed-income securities to finance telephone operations. The debt of a company includes short-term and long-term issues.[271] Part 65 requires each of the RHCs to perform detailed calculations to determine their embedded cost of debt, as reflected in the position statements (Form 10-K or 10-Q) the RHC recently filed with the Securities and Exchange Commission. In the 1990 represcription proceeding, we used the average of the RHCs' embedded costs of debt as one component of overall cost of capital calculation.[272]

93. In the Notice, we stated that we intended to consider using groups other than the RHCs in our cost of debt determination. Although the RHCs own the BOCs, they also have expanded into other ventures, both domestic and international. As they expand into new areas, their financial similarity to LECs providing interstate access service decreases substantially, and they cease to have the same risk-return properties. We, therefore, proposed to base our cost of debt determination on the debt costs of the BOCs, LECs with $100 million or more in annual revenues, and holding companies that own those LECs. We also proposed simplifying the method of calculating the embedded cost of debt. Section

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[270] See supra Section IV.B.3.

[271] Long-term debt is debt with a term of one year or more. All other debt is short-term.

[272] 1990 Represcription Order, 5 FCC Rcd at 7510, para. 28.

65.301 of our rules[273] presently requires the RHCs to consider separately each outstanding debt issue in calculating that component. We proposed to calculate any given company's embedded cost of debt by dividing the company's annual interest expense by its average outstanding debt during that year.[274]

94. In the event we continued to require separate consideration of each outstanding debt issue, we proposed replacing our current method of calculating the embedded cost of debt with the interest method, which is consistent with generally accepted accounting principles ("GAAP").[275] When companies issue debt at a premium above or a discount below the principal amount stated on the debt instrument, the effective rate of interest on the issue differs from the rate stated on that instrument.[276] Under GAAP, carriers account for premiums and discounts using the interest method. This method provides that the interest rate for each instrument equals the actual amount of interest expense implicit in the debt transaction. That rate is known when the debt is issued and remains constant over the term of debt.[277]

95. All the methods described above rely on the debt of discrete groups of carriers or their holding companies. As an alternative to these methods, we proposed to base our cost of debt determination on publicly available data regarding corporate debt. To compute long-term debt under this alternative, we proposed to use a composite of the yields on a random sample of outstanding corporate bonds rated "Aa" or better by Moody's. To compute short-term debt, we proposed to use the ten-day average of unsecured notes sold through dealers by major corporations.[278] We invited comment on all these matters.[279]

### 2. Comments

96. A number of commenters favor a composite cost of debt based on BOC data.[280] They contend that the BOCs' ARMIS reports contain all information necessary to compute

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[273] 47 C.F.R. §65.301.

[274] Notice, 7 FCC Rcd at 4698, paras. 77-78.

[275] Id. at 4698, para. 79.

[276] The effective rate of interest is lower with premiums and higher with discounts.

[277] See, e.g., Welsch and Zlatkovich, Intermediate Accounting, 641, 651-56 (8th ed. 1989). See also Notice, 7 FCC Rcd at 4698, para. 79.

[278] Notice, 7 FCC Rcd at 4698-99, para. 80.

[279] Id. at 4698, paras. 76-77.

[280] See, e.g., Centel Comments at 13; FWA Comments at 10; SWBT Comments at 2-3; United Comments at 8; USTA Comments at 66.

their composite cost of debt, are readily available, and conform to the Commission's Uniform System of Accounts.[281] SWBT argues that using these data would simplify the represcription process and be administratively efficient.[282] Other commenters maintain that relying on ARMIS data would eliminate any need for the Commission separately to determine the cost of short-term and long-term debt[283] or to determine a general corporate cost of debt.[284] NTCA points out that many state public utility commissions already rely on ARMIS data to determine the cost of debt.[285] United and USTA suggest that the Commission codify the ARMIS method in the rules, since it does not rely on an evolving financial theory.[286]

97. FWA, on the other hand, supports continuing the use of the RHCs' embedded cost of debt.[287] MCI favors using a composite of the embedded costs of debt of holding companies that own LECs earning revenue of $100 million or more annually, including the RHCs. This group includes the owners of all large and medium-size non-price cap LECs as well as the RHCs. MCI argues that, if the price cap LECs will be affected by the rate of return prescribed under the revised Part 65 procedures, then RHC debt costs should play a role in establishing the cost of debt for rate of return purposes.[288]

98. SBA states that the alternatives for calculating the cost of debt contained in the Notice are invalid, because the RHCs and the General Telephone Operating Companies ("GTOCs") are not subject to conventional rate of return regulation. SBA states that over 1250 of the 1300 rate of return LECs have annual revenues under $100 million and that the vast majority of these 1250 LECS have annual revenues under $40 million. SBA also states that these LECs do not issue stock or corporate bonds that are traded on the NYSE or American Stock Exchange. Consequently, SBA contends, it is doubtful that these companies could acquire debt at the same cost as the RHCs or GTOCs. SBA states that the Commission should base its cost of debt determination on debt costs of companies that face risks similar to those the rate of return LECs face. SBA, therefore, recommends that the Commission use a composite of these LECs' embedded costs of debt, which would take into

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[281] Centel Comments at 13; FWA Comments at 10; NTCA Comments at 5; Rochester Comments at 27-28; SWBT Comments at 2-3; United Comments at 8; USTA Comments at 66.

[282] SWBT Comments at 2-3.

[283] Rochester Comments at 27-28; USTA Comments at 67. See also SWBT Comments at 3.

[284] USTA Comments at 67-68.

[285] NTCA Comments at 5.

[286] United Comments at 8; USTA Comments at 67-69.

[287] FWA Comments at 10.

[288] MCI Comments at 28-29.

account the commercial, state, and federal financing of these carriers.[289]

99. The small LECs commenting in this proceeding oppose SBA's recommendation. These commenters state that any new rules adopted by the Commission should not use the capital costs or financial structures of the 1300 LECs regulated under rate of return. They state that the data for these carriers would be very costly to collect, would not be internally consistent, and in many cases would not be available. These commenters maintain that the capital structures and debt costs of the BOCs provide the best surrogate for the interstate access service costs of small LECs. They further state that the BOC data is representative of the industry as a whole, and can be averaged into composite industry figures and applied to the rate of return carriers.[290]

100. FWA contends that publicly available data on corporate debt would provide a reasonable proxy for the cost of debt for LEC interstate access services and would help the Commission establish a valid range for that cost in a represcription proceeding.[291] MCI, however, states that the Commission should not commit itself to using corporate debt data until it has determined how to isolate such debt costs. MCI argues that nothing in the record in this proceeding shows, for example, that a random sample of corporate bonds rated Aa or better would approximate the cost of debt for LEC interstate access service.[292]

101. USTA asserts that the methods the Notice proposed for calculating the costs of corporate debt are unnecessarily complex. USTA contends that a random sample of bonds would be inappropriate and less accurate than published composite averages such as Moody's Aa utility bond yield averages. USTA also points out that the Notice does not make clear what source the Commission would use to determine short-term debt costs. USTA suggests using a published source, such as the Federal Reserve Statistical Release G.13, which shows the monthly rate on six-month commercial paper.[293]

102. As indicated above, most cost of debt commenters support our proposal to simplify the method for calculating the embedded cost of debt. USTA states that individual calculations are burdensome, are no more accurate than composite calculations, and have no regulatory purpose.[294] Several commenters maintain that we should adopt the interest method

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[289] SBA Comments at 14-15.

[290] See, e.g., Delhi Comments at 1-2; Lexington Comments at 1-2; Mid-Iowa Comments at 1-2; OPASTCO Comments at 3; Rural Service at 1-2.

[291] FWA Comments at 11.

[292] MCI Comments at 29.

[293] USTA Comments at 68.

[294] Id. at 66.

of calculating the cost of debt.[295] Centel, United, and USTA state ARMIS data already incorporate this method.[296] United and USTA recommend that any cost of debt methodology we adopt not be binding in future represcription proceedings.[297]

### 3. Discussion

103. We adopt a composite cost of debt based on the embedded cost of debt of all LECs with annual revenues of $100 million or more.[298] We will calculate this composite using ARMIS data for these LECs as set forth in the following equation:

$$\text{Embedded Cost of Debt} = \frac{\text{Total Annual Interest Expense}}{\text{Average Outstanding Debt}}$$

The results of this calculation will be presumptive in future represcription proceedings. If the triggering event occurs,[299] we will apply this methodology and include its results in the notice inquiring into whether a represcription proceeding should be initiated. This will provide all interested parties an opportunity to comment on this methodology and to suggest alternative methodologies for estimating the cost of debt for LEC interstate access service. The Common Carrier Bureau, of course, will be able to obtain through data requests any data required to apply any alternative methodology.

104. We adopt this presumptive methodology because, more than any alternative method, it promises to further our goal of simplifying future represcription proceedings without sacrificing needed accuracy. Because it relies on ARMIS data, this methodology eliminates the need for the burdensome review of individual debt issues required by our current rules. It also incorporates the GAAP interest method for computing bond discounts and premiums. In addition, by relying on data regarding all LECs with annual revenues of $100 million or more, rather than BOC data or holding company data, the methodology appears to provide a reasonable proxy for the cost of debt the rate of return LECs incur in the provision of interstate access services.

105. SBA recommends that we use a composite of the rate of return LECs' embedded costs of debt to determine the cost of debt component. At present, however, we do not obtain on a routine basis data that would allow us to apply SBA's methodology.

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[295] SWBT Comments at 3; Centel Comments at 13; FWA Comments at 11; United Comments at 8-9; USTA Comments at 67. We describe this method in supra para. 94.

[296] Centel Comments at 13; United Comments at 8-9; USTA Comments at 67.

[297] United Comments at 8; USTA Comments at 69.

[298] We do not require average schedule companies to file ARMIS reports.

[299] See supra Section IV.A.

Moreover, we agree with the small LEC commenters that we should not impose a data collection requirement on them to implement SBA's recommendation. Instead, we should rely on our ARMIS data to obtain a reasonable surrogate for the interstate access service costs of small LECs. We, therefore, are not adopting SBA's recommendation in this Order. If it appears that knowing the small LECs' actual costs of debt may help us determine whether a represcription proceeding is warranted or increase substantially the accuracy of a future represcription, we will obtain the necessary data at that time.

## E. Cost of Preferred Stock

### 1. Overview

106. Part 65 treats preferred stock in the same manner as short-term debt. The cost of preferred stock is the most recently available embedded dividend cost (i.e., dividend divided by book value) as of the initial filing in a represcription proceeding.[300] In the Notice, we invited comment on whether we should continue to include a preferred stock component within the capital structure we use to determine the cost of capital for LEC interstate access service.[301] We proposed, if we retained a preferred stock component, to continue treating preferred stock like debt. We invited comment on whether we should apply any of the proposed cost of debt methods to determine the cost of preferred stock. We stated, for example, that if we were to calculate the cost of debt component by dividing total annual interest expense by average outstanding debt, we could calculate the preferred stock component by dividing total annual dividends on preferred stock by total net proceeds from the issuance of outstanding preferred stock.[302]

### 2. Comments

107. Centel maintains that a method for computing the cost of preferred stock is necessary, only if we adopt a capital structure that recognizes preferred stock as a separate capital structure component. For example, Centel indicates, if the BOCs' capital structures are used, no methodology for computing the cost of preferred stock would be necessary, because the BOCs have no preferred stock.[303] Other commenters state that the rules should include a methodology for computing the cost of preferred stock, because BOCs may issue this type of stock in the future or another type of capital structure may be adopted.[304]

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[300] See 47 C.F.R. §65.302. See also 84-800 Phase II Order, 51 Fed.Reg. at 1803.

[301] Notice, 7 FCC Rcd at 4699-500, para. 86.

[302] Id. at 4699, para. 82.

[303] Centel Comments at 13-14.

[304] United Comments at 9; USTA Comments at 69.

108. In the event we adopt a capital structure that includes preferred stock, the commenters argue that we should calculate the cost of preferred stock in a manner similar to cost of debt.[305] United and USTA suggest ARMIS data can be used to determine the cost of preferred stock.[306] USTA states that there is no need to identify separate preferred stock issues.[307] USTA states further that any preferred stock methodology should specify a methodology for estimating net proceeds as a percentage of face value, since ARMIS reports do not show the net proceeds and amortization of issuance costs, discounts, and premiums on preferred stock.[308] FWA states that the current rules treat preferred stock correctly.[309]

### 3. Discussion

109. In a subsequent portion of this Order,[310] we determine that the composite capital structures of all LECs with annual revenues of $100 million or more should be presumptive in future represcription proceedings. Although these LECs' capital structures currently include no preferred stock, our rules should recognize that they may issue such stock in the future. We also believe, consistent with the commenters' views, that we should treat preferred stock like debt. Therefore, we will calculate the cost of preferred stock using ARMIS data for these LECs, as set forth in the following equation:

$$\text{Cost of Preferred Stock} = \frac{\text{Total Annual Dividends on Preferred Stock}}{\text{Proceeds from the Issuance of Outstanding Preferred Stock}}$$

110. As with the cost of debt methodology, this preferred stock methodology will be presumptive in future represcription proceedings. Although USTA suggests that we should specify a method for estimating net proceeds as a percentage of face value, we believe any resulting adjustment would likely have little effect on represcription results. LECs now have very little preferred stock outstanding, and we are aware of no plans for LECs to issue substantial amounts of it in the future. Therefore, any adjustments to implement USTA's suggestion would most likely be negligible. In these circumstances, we decline to specify a method for making such adjustments at this time. If a party to a future represcription proceeding believes that the differences between net proceeds and face values are substantial, it may suggest appropriate adjustments at that time.

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[305] Centel Comments at 14; USTA Comments at 69; FWA Comments at 11.

[306] United Comments at 9; USTA Comments at 69.

[307] USTA Comments at 69.

[308] Id. at 60-70.

[309] FWA Comments at 11.

[310] See infra Part V.F.3.